KROES ENERGY INC.

1996 ANNUAL REPORT

CORPORATE PROFILE

Kroes Energy Inc. is a junior oil and gas exploration and production company listed on the Alberta Stock Exchange. It is the objective of the Company to acquire producing properties in western Canada and to participate in oil and gas ventures outside of Canada.

The Company presently has interests in crude oil and associated gas production in western Saskatchewan and during 1997 will earn a 7.5% working interest in an exploration project containing 11,500 square kilometers offshore Cuba.

DIRECTORS

Stephan V. Benediktson
Cochrane, Alberta

Fred Callaway
Calgary, Alberta

N. (Bill) Khouri
Calgary, Alberta

David E. Powell
Calgary, Alberta

Richard A. Wilson
Calgary, Alberta

OFFICERS

Fred Callaway
President

Richard A. Wilson
Secretary

ANNUAL MEETING

The Annual Meeting of the Shareholders will be held in Calgary on June 16, 1997 at 3:00 pm in the Cardium Room of the Calgary Petroleum Club, 319 - 5Ave. SW.

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1996 ANNUAL REPORT

PRESIDENT'S MESSAGE

To the Shareholders

The Directors of Kroes Energy Inc. are pleased to report on the progress made since the Company's inception early in 1996.

In June, the founding Directors purchased share equity totalling $200,000 and a preliminary prospectus was filed with the Alberta Securities Commission under the Junior Capital Pool rules and procedures. All approvals were received and on August 20, the final prospectus was issued and McDermid St. Lawrence Securities Ltd. kicked off the public financing. The issue of 1,500,000 shares at 20 cents per share was fully subscribed and was closed on September 25 with gross proceeds of $300,000 to Kroes. The shares began trading on the Alberta Stock Exchange on October 9.

During September, negotiations were concluded for the purchase of interests held by Benson Petroleum Ltd. in oil and gas producing leases in western Saskatchewan for $850,000. The purchase price was financed by the funds received from the initial financing of Kroes and a $470,000 loan from Hogar Energy Inc., a new private company incorporated by the Directors of Kroes. Under Alberta Securities Commission policies this purchase of oil and gas reserves required shareholder approval and at a meeting on December 18, the necessary approval was received. Closing took place on December 30, 1996.

In November Hogar Energy Inc. concluded an agreement to participate in an exploration project on 3 blocks off the southern coast of Cuba. A private placement financing of $1,200,000 was put in place by McDermid St. Lawrence by issuing Hogar shares at 35 cents per share. The placement was fully subscribed and closed on December 19. The net proceeds were used to prepay Hogar's share of the cost of drilling the earning well in Cuba, amounting to $585,000, and to provide a loan of $470,000 to Kroes to complete the financing of it's major transaction.

On February 20, 1997 Kroes made a takeover bid to acquire all of the outstanding shares and warrants of Hogar on a share for share basis. The offer expired on March 14 and all shareholders accepted by tendering their shares. Following final approval by the Alberta Stock Exchange, the new Kroes shares were issued to Hogar shareholders and were available for trading on March 24.

The timing of our purchase of producing properties in Saskatchewan was very good as oil and gas prices were strong through the last quarter of 1996 and most of the first quarter of 1997. As a result, cash flows exceeded our expectations and provided an excellent start on the payout of the investment.

Our plans for the future involve acquiring more production and cash flow in Canada and to seek opportunities outside of Canada to acquire producing properties, development projects or exploration ventures. The Directors of Kroes are well known in the international oil and gas community and we are in the process of evaluating a number of opportunities that have come to our attention.

Fred Callaway, President

May 12, 1997

OPERATIONS REVIEW

CUBA

On November 29, 1996 Hogar Energy signed a participation agreement with Sherritt Oil and Gas International Ltd. to earn a 7.5% interest in Blocks V, VI and VII offshore southern Cuba by paying 10% of a well to be drilled in 1997. The agreement called for payment of Hogar's share of the estimated cost of the well in advance and US$233,000 was due on November 26 with the remaining US$200,000 due on December 27, 1996. The first payment was made using funds received from convertible loans made by two Directors and two private investors. On December 19 a private placement of $1,200,000 was completed by McDermid St Lawrence which allowed Hogar to make the final payment to Sherritt and to repay $112,000 of the loans that were not converted to equity.

Blocks V, VI and VII comprise 11,505 square kilometers (29 million acres) in the Golfo de Ana Maria and Golfo de Guacanayabo. Both bays are shallow marine lagoons with average water depth of 5-8 meters. The Golfo de Ana Maria extends northward into the onshore area of the Central Basin of Cuba where some small oil fields produce light sweet oil from reef limestones and volcanics of Cretaceous age.

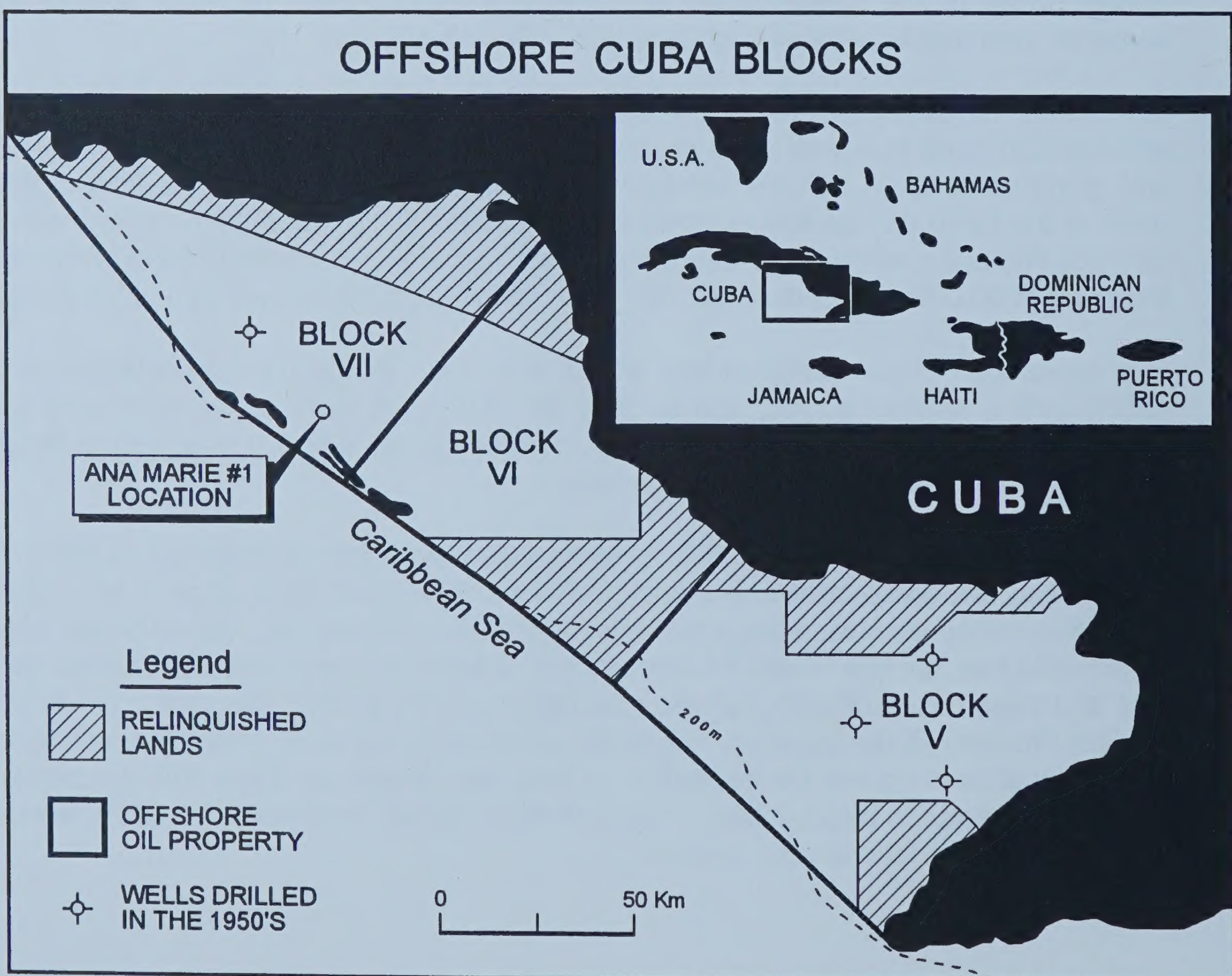
Exploration for oil and gas in Cuba started at the end of the 19th century. Some 25 small and medium sized heavy oil fields have been discovered along the Northwest coast. Oils with gravities up to 31 API are produced from several small fields in the Central Basin north of the Golfo de Ana Maria. Geochemical studies show that both the heavy and the light oils share the same deep Mesozoic source. Total production in Cuba is currently in the order of 30,000 barrels of oil per day and 3.5 million cubic feet per day of natural gas.

The exploration of the Golfo de Ana Maria and Golfo de Guacanayabo began in the 1950's with a seismic survey, and in 1957-58 four wells were drilled from coral keys adapted by dredging. Three were shallow stratigraphic tests and subsequent evaluation shows the fourth well was located off structure.

Exploration activities ceased in 1959 and the oil industry was nationalized in 1960. The next activity on these blocks occurred between 1989 and 1995 when three seismic surveys covering approximately 4,000 kilometres were carried out. Interpretation of this recent data has identified some 25 prospects and leads of which many are substantial in size and three have sufficient seismic coverage to justify drilling. The well Ana Maria #1 will test Prospect B, the largest of the three, on Block VII some 90 kilometers offshore. A conventional land rig will be located on a coral key known as Cayo Rabihorcado and drilling is expected to begin in May. The well will be drilled to a depth of 2,500 kilometers and is expected to take about 5 weeks.

Potential gross reserves for the three well defined prospects have been estimated using average porosity of 20%, average water saturation of 30% and a recovery factor of 35% (equivalent to an average recovery of 400 bbls per acre foot).

Prospect B (Cretaceous) Ana Maria #1	Closed area: 44,000 acres Average net pay (assumed): 100 feet Recoverable reserves: 1,760 million barrels
Prospect D (Middle Eoc.)	Closed area: 8,400 acres Average net pay (assumed): 100 feet Recoverable reserves: 336 million barrels
Prospect F (Cretaceous)	Closed area: 8,000 acres Average net pay (assumed): 100 feet Recoverable reserves: 320 million barrels



The production sharing contract has excellent terms and in the event of a discovery, revenues will be shared with the government at rates that vary with production volumes up to 100,000 barrels per day. Costs will be recovered from early production and no royalties or corporate taxes are payable. Modest bonus payments are applicable at start of production and when production reaches various increments up to 100,000 BOPD.

There is no evidence to date of any residual claims on Blocks V, VI or VII as a result of the nationalization of the oil industry in Cuba that could result in scrutiny under the Helms-Burton Law in the United States.

CANADA

On October 1, 1996 Kroes Energy Inc. acquired producing oil and gas properties from Benson Petroleum Ltd in the Druid, Eureka and Whiteside fields of western Saskatchewan. Proved and probable reserves were 150,200 barrels of light crude oil and 210 million cubic feet of associated natural gas. The unit cost of the reserves was $4.96 per barrel of oil equivalent.

The properties consist of an average 27.2% interest in leases in the Druid area, 16% in the Eureka field and 30.4% in the Whiteside area. For the last quarter of 1996, daily production averaged 66 barrels of crude oil and 103,000 cubic feet of natural gas. Net cash flow generated from the properties for the quarter was in excess of $104,000. There is modest development potential in the Druid and Whiteside fields and it is expected that two wells will be drilled in each of these during 1997.

Although the effective date of the acquisition was October 1, accounting principals established by the Canadian Institute of Chartered Accountants require that closing adjustments, including cash flow received from the effective date to the closing date, be treated as an adjustment to the purchase price. Thus, no operating revenue or expense has been recorded in the Company's records for 1996 and the carrying cost of the acquired properties has been reduced to $804,921. Administrative expenses were minimal in 1996 as the Company paid no salaries and its office did not open until July 1.

Price Waterhouse

January 24, 1997

AUDITORS' REPORT

To the Shareholders of
Kroes Energy Inc.

We have audited the balance sheets of **Kroes Energy Inc.** as at December 31, 1996 and June 7, 1996 and the statements of operations and deficit and changes in financial position for the periods ended December 31, 1996 and June 7, 1996. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these financial statements present fairly, in all material respects, the financial position of the Company as at December 31, 1996 and June 7, 1996 and the results of its operations and the changes in its financial position for the periods ended December 31. 1996 and June 7, 1996 in accordance with generally accepted accounting principles.

Price Waterhouse

Chartered Accountants
Calgary, Alberta

BALANCE SHEET

	December 31 1996	June 7 1996
Assets		
Current		
Cash	$ 2,952	$ 193,000
Accounts receivable	88,530	-
Prepaid expenses and deposits	40,111	-
	131,593	193,000
Deposit for financing	-	7,000
Capital assets *(Note 3)*	804,921	-
	$ 936,514	$ 200,000
Liabilities		
Current liabilities		
Accounts payable and accrued liabilities	$ 25,490	$ -
Current portion of Promissory Note *(Note 4)*	56,000	-
	81,490	-
Promissory Note *(Note 4)*	414,000	-
Shareholders' Equity		
Share capital *(Note 5)*		
Common Shares issued	459,207	200,000
Deficit	(18,183)	-
	441,024	200,000
	$ 936,514	$ 200,000

Approved by the Board ______________ **Director** ______________ **Director**

STATEMENT OF OPERATIONS AND DEFICIT

	Period ended December 31 1996	Period ended June 7 1996
Revenue		
Interest income	**$ 2,815**	$ -
Expenses		
General and administrative	**12,618**	-
Office rent	**8,380**	-
	20,998	-
Net loss for the period and deficit at December 31, 1996	**$ (18,183)**	$ -
Net loss per share	**$ 0.01**	$ -

STATEMENT OF CHANGES IN FINANCIAL POSITION

	Period ended December 31 1996	Period ended June 7 1996
Cash used in operating activities		
Net loss for the period	**$ (18,183)**	$ -
Change in non-cash working capital	**(103,151)**	-
	(121,334)	-
Cash provided by (used in) financing activities		
Issue of Common Shares for cash	**259,207**	200,000
Promissory Note	**470,000**	-
Deposit for financing	**7,000**	(7,000)
	736,207	193,000
Cash used in investing activities		
Purchase of capital assets	**(804,921)**	-
Change in cash for the period	**(190,048)**	193,000
Cash at beginning of period	**193,000**	-
Cash at end of period	**$ 2,952**	$ 193,000

NOTES TO FINANCIAL STATEMENTS
December 31, 1996

1 Incorporation

The Company was incorporated under the Business Corporations Act (Alberta) on December 20, 1995. During the period to June 7, 1996, the Company was inactive. By a prospectus dated August 20, 1996, the Company issued 1,500,000 shares to the public under a junior capital pool offering. On December 30, 1996, the Company completed its major transaction which was the purchase of oil and gas properties for a net cash cost of $804,921.

2 Significant accounting policies

(a) Full cost method of accounting
The Company follows the full cost method of accounting whereby all costs relating to the exploration for, and the development of, oil and natural gas reserves are capitalized on a country-by-country cost centre basis. Costs accumulated within each cost centre are depleted and depreciated using the unit-of-production method, based on estimated proved reserves with production and reserves volumes of natural gas converted to equivalent energy units of crude oil. Proceeds from disposal of properties are normally deducted from the cost centre except when the disposition results in a significant change in the depletion rate in which case a gain or loss on disposal is recognized.

Costs of exploration in new cost centres, together with related land costs, are excluded from costs subject to depletion until it is determined whether or not proved reserves are attributable to the properties, or if impairment has occurred.

In determining the depletion and depreciation provisions for oil and natural gas assets, the Company includes any excess of the net book value of those oil and natural gas assets over the unescalated, undiscounted future net operating revenues from its proved oil and natural gas reserves for each cost centre (ceiling test). A second ceiling test calculation is conducted on an enterprise basis, by including in the depletion and depreciation provisions any excess of the net book value of oil and natural gas assets less deferred taxes and the future dismantlement and site restoration costs for all cost centres over the unescalated, undiscounted future net revenues from proved oil and natural gas reserves, plus the cost of undeveloped properties, less future general and administrative expenses, financing costs and income taxes.

(b) Future dismantlement and site restoration costs
Estimated future dismantlement and site restoration costs for oil and gas assets are provided using the unit-of-production method. The expense is included in depreciation and depletion.

(c) Joint ventures
Substantially all of Kroes's oil and gas exploration, development and production activities are conducted jointly with others. The financial statements reflect only Kroes's proportionate interest in such activities.

(d) **Foreign currency translation**
- Monetary assets and liabilities - at the period-end rate of exchange.
- Other assets and liabilities - at historical rates of exchange
- Revenues and expenses - at monthly rates of exchange except provisions for depletion and depreciation which are translated on the same basis as the related assets.

Unrealized gains and losses on translation to Canadian dollars of long-term monetary assets and liabilities are deferred and amortized over the remaining lives of the related assets and liabilities.

(e) **Net income (loss) per share**
Net income (loss) per share is calculated using the weighted average number of shares outstanding. Fully diluted earnings per share is calculated as if all outstanding stock options were exercised at the beginning of the year.

3 *Capital assets*

	Cost at December 31 1996
Intangible oil and gas properties	$ 649,176
Tangible oil and gas equipment	155,745
	$ 804,921

The acquisition cost of the capital assets was adjusted by GST, closing adjustments and operating cash flow from the effective date of October 1, 1996 to the closing date.

4 *Promissory note*

Hogar Energy Inc. ("Hogar") loaned the Company $470,000 bearing interest at prime plus 1.25% (6.0% at December 31, 1996, which amount is subject to interest rate change risk), secured by a promissory note and a security agreement on the Company's properties and repayable at $8,000 per month starting June 1, 1997. (Repayments: $56,000 in 1997; $96,000 in 1998, 1999, 2000, 2001 and 2002 and $30,000 in 2003.) (See Note 7.)

NOTES TO FINANCIAL STATEMENTS ...continued
December 31, 1996

5 Share capital

The Company's authorized share capital is an unlimited number of Common Shares and an unlimited number of Preferred Shares issuable in series. No Preferred Shares have been issued.

Common Shares issued:

2,000,000	at $0.10 - outstanding June 7, 1996	$ 200,000
1,500,000	at $0.20 in junior capital pool prospectus (net of commission and other costs of $55,793)	244,207
75,000	at $0.20 exercised under agent's options	15,000
3,575,000	Issued and outstanding at December 31, 1996	$ 459,207

2,045,000 Common Shares are held in escrow and may not be traded, released, transferred or dealt with in any manner without the consent of the Executive Director of the Alberta Securities Commission. 2,005,000 of these shares were issued to directors, officers and the promoter of the Company.

Options to purchase 350,000 Common Shares at $0.20 per share were granted to directors and officers of the Company. The options expire September 24, 2001. Options to purchase 150,000 Common Shares at $.20 per share were granted to the agent for the prospectus. Options for 75,000 shares were exercised and options for 75,000 shares expire October 9, 1998.

See Note 7.

6 Income taxes

The Company has estimated income tax losses of $18,000. No provision for any benefit related to these losses has been recorded. The Company has income tax pools for intangible costs and tangible costs of approximately $649,000 and $156,000 and share issue costs of $56,000 which can be claimed for tax purposes in future years.

7 Subsequent event

Subsequent to December 31, 1996, the Company indicated that it was proposing to purchase all of the outstanding shares of Hogar. The Company and Hogar have common management and directors. The Company would issue Common Shares for the Class B Common Voting Shares of Hogar on a 1 for 1 basis. Hogar's only business activities to December 31, 1996 were to raise $1,200,000, lend $470,000 to the Company and sign a Participation Agreement to earn an interest in an oil and gas project in Cuba by drilling an exploratory well and advance $586,149 to the operator of this project. Drilling had not commenced at December 31, 1996.

NOTES TO FINANCIAL STATEMENTS ...continued
December 31, 1996

The acquisition will be accounted for as a purchase. If the acquisition is completed, the purchase price equation would be as follows:

Cash	$ 16,522
Accounts receivable	2,509
	19,031
Promissory note receivable	*470,000
Advances under Participation Agreement	586,149
	1,075,180
Accounts payable	(32,744)
Purchase price prior to acquisition costs	$ 1,042,436

* The Promissory note is receivable from the Company and would be eliminated on consolidation.

CORPORATE INFORMATION

Offices

260, 435 - 4 Ave SW
Calgary, Alberta, Canada
T2P 3A8

tel 403 265 7711
fax 403 265 7733

Bankers

Bank of Nova Scotia
Calgary, Alberta

Auditors

Price Waterhouse
Calgary, Alberta

Solicitors

McCarthy Tetrault
Calgary, Alberta

Transfer Agent

Montreal Trust
Calgary, Alberta

Stock Exchange Listing

Alberta Stock Exchange
Trading Symbol: KRS

Kroes Energy Inc.